

**COORDINATED ISSUE  
COMMERCIAL BANKING  
ACCRUED INTEREST ON NONPERFORMING LOANS**

**ISSUE**

Whether an accrual basis bank should continue to accrue interest on delinquent loans placed in a non-accrual status.

**FACTS LAW AND ARGUMENTS**

The bank is on the accrual method of accounting and has an ongoing policy of not accruing into income interest on loans which they deem are nonperforming but have not as yet been written off as bad debts. Nonperforming loans are those loans which, as a result of the inability of the borrower to meet the contractual terms of the loans, are delinquent and are placed on a non-accrual basis. A non-accrual basis means that even though the loans still remain on the books, the taxpayer stops accruing interest income on these loans. Three general criteria, though not all conclusive, used by banks to determine if a loan is delinquent are:

- 1- The loan account is considered delinquent when payments have not been received after predetermined number of days (i.e., 30, 60, 90 days, etc.). The principal is placed in non-accrual status but no part of the loan is charged to the Reserve for Bad Debts.
- 2- A partial write-off is made to the reserve account and the balance of the loan account is placed in non-accrual status.
- 3- The loan account is in the process of being restructured or renegotiated.

Section 451(6) of the Code states "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period."

Regulation 1.451(a) states "...Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy..."

The taxpayers have stated that under state banking law interest income should not be accrued on loans where the principal and/or interest is past due for a stated number of

days. Revenue Ruling 68-220, 1968-1 C.B. - 194, generally provides, in part, that where an administrative agency requires a method of accounting as to a particular item, this accounting treatment is not controlling for Federal Income Tax purposes.

In Greer-Robbins Co. v Commissioner, 119 F. 2nd 92 (9th.cir-1941) it was held that in determining whether interest is of doubtful collectibility, the burden of proof was on the taxpayer to show the bad debt character of the accrued interest. Letter Ruling 7944014 held that delinquent loans should have been accrued in income under the accrual method of accounting. This letter ruling further states that "A taxpayer may not have to accrue interest income...if there exists no reasonable expectation at the time of accrual that the items of income ... will be ... collected. Such an expectation must be judged by the facts. Broderick v Anderson , 23 F. Supp 488 (S.D..N.Y. 1983). Furthermore, taxpayers have the burden of proof that such items of interest income...are not collectible...".

It is to be noted that a technical advice applicable to one taxpayer can not be specifically applied to another taxpayer. However, where the facts involved in each case are basically the same, the rationale and statutes in a given technical advice may be followed in the case of another taxpayer.

Revenue Ruling 77-135, 1977-1 C.B., 133, although dealing with interest income and interest expense regarding graduated payment mortgages, further elaborates on the above section of the regulation as follows:

"...with respect to the accrual basis taxpayer, all the events that fix the right to received income occur when (1) the required performance occurs, (2) payment therefore is due, or (3) payment therefore is made, whichever happens earliest."

In applying this rule to the accrual of interest income, performance occurs when the lender allows the borrower to use the lenders money. When the lender has done this for any one day, one day's performance has occurred and one day's interest accrues (assuming that payment has not already been made).

In view of the above citations it is clear that an accrual basis taxpayer who has a right to receive income is obligated to accrue into income all amounts due with respect to loans negotiated with debtors.

It is also to be noted that the right to receive income (upon the sale of property) was decided in a Supreme Court Case, Spring City Foundry Co. v Commissioner 292 U.S. 182 (134), where income was held to be included in gross income, notwithstanding that said receivable later became uncollectible by reason of the debtor's bankruptcy in the same year. The court in that case went on to hold that the taxpayer's remedy was

through an appropriate bad debt deduction. However, it was clear that at the time of the sale, the receivable was presumably worth its face amount or an amount substantially equal thereto. The event of worthlessness, even though in the same year, was a subsequent transaction. In effect, two separate transactions are involved; the first dealing with an income inclusion and the second dealing with a possible write-off of said interest income receivable subsequently thereto.

The above conclusions appear to be inconsistent with the conclusions reached in Corn Exchange Bank v. U. S., (CA-2), 2USTC 455; 37F. 2d 34 and in Suffolk & Berks, Marguerite H., 40 BTA 1121, Dec. 10,925 (Acq). The distinction between these cases appears to be reconciled in Atlantic Coast Line Railroad Co.v. Comm. 31 BTA 730 (1934) at 749-751. The court, having determined as a matter of fact that the taxpayer had no reasonable expectation of payment of interest on certain notes, held that the interest was not required to be accrued. The court stated "The meaning of the language used by the Supreme Court in (Spring City) must be sought in the light of the facts of that case at the time (Spring City's) right to receive arose; it is not shown that the debtor was insolvent or that the debt was not good and collectible. The fact that the obligation later became worthless in part, even though within the same taxable year, is therefore immaterial, as stated by the Court. The question then turned to the deduction which might be taken according to Sec. 166 of the Code. But where the obligation is worthless at the time the right to receive arises, as in the instant case, the right to receive is without substance and there is in fact nothing to accrue. Accrual of a worthless item in such circumstances obviously results in a distortion of gross income and in our opinion the Court did not intend its reasoning to be so applied as to reach the same result on a materially different state of facts".

Thus it can be seen that there appears to be agreement on the basic law in the area, however it is not believed that merely because an account becomes 30 days or more past due that there is little or no likelihood of collection in the future. What the above cases have in common is a showing of worthlessness as that term is used in Section 166(a) of the Code.

This issue was covered in Revenue Ruling 80-361, 1980-2 C.B., 164. In accordance with that ruling, if and when a loan becomes uncollectible, the interest should be accrued to the point of uncollectibility. The accrued interest receivable, if not collected, should be treated as accrued interest on a bad debt pursuant to Section 166 of the Code and charged to the reserved account.

It is recommended that the taxpayer should continue to accrue interest on all loans until they have substantiated that one of the following requirements have been met. The meeting of these requirements must be on a loan by loan basis and subject to audit verification by the I.R.S.:

- 1- If a bank, which is subject to supervision by Federal authorities, or by state authorities maintaining substantially equivalent standards, has been given written specific instructions by a regulatory agency that a loan, in whole or part, should be charged off as a bad debt, then on the amount so charged no further interest should be accrued. Interest should continue to be accrued up until the date the account is so charged off. Previously accrued but uncollected interest relating to the amount written off should be charged to the reserve account.
- 2- On loans not charged off, the taxpayer must, on a loan by loan basis, substantiate that the interest is uncollectible in accord with Revenue Ruling 80-361.

It is the taxpayer's responsibility to present to the examiner a schedule showing the detailed specifics of how the non-accrued interest was derived. Usually the annual report will contain just a summary figure of this amount. It is only by working with a detailed schedule that we will be able to do a proper audit of this area.